SIG
SUSQUEHANNA INTERNATIONAL GROUP, LLP
401 CITY AVENUE. SUITE 220. BALA CYNWYD, PA 19004-1188. 610.617.2600. WWW.SIG.COM
AMSTERDAM BALA CYNWYD CHICAGO DUBLIN NEW YORK PHILADELPHIA SAN FRANCISCO SYDNEY

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OFFICE OF THE SECRETARY

Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Amendments to Financial Responsibility Rules for Broker-Dealers
(Release No. 34-55431; File No. S7-08-07)

Dear Ms. Morris:

Susquehanna International Group, LLP ("SIG") appreciates the opportunity to comment on the Securities and Exchange Commission's (the "SEC" or "Commission") proposed amendments to its financial responsibility rules in Release No. 34-55431, 72 FR 12862 (Mar. 19, 2007) (the "Proposing Release" or "Release"). Although the date for public comment has elapsed, SIG has material concerns about the proposed restriction on capital withdrawals, and accordingly submits this comment letter.

SIG supports the Commission's interests in safeguarding the liquidity of broker-dealers, but the instant proposal to re-characterize capital as a liability goes too far, is ambiguous on key points, and will compromise liquidity by dissuading capital contributions. We suggest several alternatives to the proposal that we believe better balance the need to assure broker-dealer liquidity with legitimate needs to withdraw excess net capital and provide certainty to broker-dealers and their affiliates.

The Capital Treatment Proposal

The Proposing Release expressed the Commission's concern that broker-dealers may be receiving capital contributions from individual investors that are subsequently withdrawn after a short period of time, which it regarded as at least less than a year. The Commission noted its belief that capital contributions to broker-dealers should not be temporary, and should be treated as a liability if it is made with the understanding that the contribution can be withdrawn at the option of the investor. The Commission proposed to add paragraph (c)(2)(i)(G) to Rule 15c3-1, to require a broker-dealer to treat as a liability any capital that is contributed under an agreement giving the investor the option to withdraw it. The provision also would require a broker-dealer to treat as a liability any capital contribution that is intended to be withdrawn within a year unless the broker-dealer receives written permission from its designated examining authority. A withdrawal made within one year of the contribution would be presumed to have been intended to be withdrawn within a year and, therefore, presumed to be subject to the deduction.

The Commission seeks to codify its belief that capital should be permanent and not temporary, but this belief is without legal basis and has significant problems that are propagated in the proposed amendment. Rule 15c3-1 contains no requirement that capital must be permanent, and the word "capital" has no intrinsic meaning that requires it to be permanent. Neither Delaware law nor Generally Accepted Accounting Principles ("GAAP") contain such requirement. The treatment of capital as a liability would contravene GAAP, creating a conflict that would necessitate separate net capital accounting and GAAP accounting.[1] Because the contributed capital stands behind creditor claims against a broker-dealer, and in every other way has the legal attributes of capital, there is no basis to treat any such monies as a liability.

The concepts of permanence and temporariness in the context of capital contributions are undefined and ambiguous. Without some qualification, permanence entails remaining in perpetuity, and anything short of that is by definition temporary. As a permanence requirement has no basis and makes no sense in relation to capital contributions, it is not required of non-broker-dealers. Investors do not simply abandon their money when they contribute capital, so in every case there is an expectation that the invested money is capable of being redeemed.

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[1] Statement of Financial Accounting Concepts No. 6 ("Statement No. 6"), *Elements of Financial Statements*, at paragraphs 35 and 36, define "liabilities" as "probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events." It notes, "A liability has three essential characteristics: (a) it embodies a present duty or responsibility to one or more other entities that entails settlement by probable future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand, (b) the duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice, and (c) the transaction or other event obligating the entity has already happened."

In discussing the characteristics that distinguish liabilities and equity, paragraph 54 of Statement No. 6 notes, "A business enterprise may distribute assets resulting from income to its owners, but distributions to owners are discretionary, depending on the volition of owners or their representatives after considering the needs of the enterprise and restrictions imposed by law, regulation, or agreement....An enterprise's liabilities and equity are mutually exclusive claims to or interests in the enterprise's assets by entities other than the enterprise, and liabilities take precedence over ownership interests."

These descriptions make clear that the mere distribution of assets to the owners of a business upon the volition of such owners does not recast such assets as a liability. The Staff's proposed recasting of capital contributions as a liability, then, would be inaccurate under generally accepted accounting principles.

The arresting of invested capital will dissuade capital contributions above minimum net capital requirements. This chilling effect will of course reduce the liquidity cushions provided by excess net capital, which is the opposite of the Commission's intended effect on the market.

The instant proposal seems to be an attempt to codify the advice in an SEC Staff letter to Raymond Hennessy and Susan DeMando (representatives of, respectively, the NYSE and NASD) dated February 23, 2000. That letter dealt with a scenario typical of "day trading" firms, where (1) a broker-dealer received capital contributions from an individual investor, (2) the individual investor actively traded the firm's proprietary account, and (3) the individual could withdraw not only trading profits, but capital contributions, pursuant to an agreement with the firm. The Staff concluded in that case that the investor's capital contributions should be re-characterized as a liability. The instant proposal, however, seeks to expand the letter's advice to all broker-dealers, which flies in the face of the "Drexel Rules" discussed below.

The Release does not attempt to reconcile the instant proposal with the fact that existing withdrawal limitations and notification provisions under Rule 15c3-1(e) already provide early warning protection to facilitate timely regulatory responses to troubled broker-dealers. In adopting these provisions in 1991 as a response to the Drexel Burnham failure, the Commission announced its belief that they would "strike an appropriate balance between the need for increased early warning protection and the ability of broker-dealers to allocate their resources efficiently." *SEC Release No. 34-28927 (Feb. 28, 1991).* The Commission also noted that "the early warning levels also prevent the broker-dealers from favoring owners of the firm to the detriment of its customers or other creditors by placing restrictions on the withdrawal of equity capital." *Id.* Having already addressed these concerns, and making out no case that the 1991 amendments are somehow inadequate today, the Commission's instant proposal would frustrate its previously established "appropriate balance".

Legitimate Withdrawal Needs

We understand how transient capital infusions by individual investors to allow broker-dealers to temporarily meet minimum net capital requirements may be problematic. But there are valid and important reasons to have the flexible ability to withdraw capital within a year of contribution.

SIG is the parent company of multiple broker-dealers providing liquidity in various securities and commodities markets. In order to optimally manage the dynamic risk of these operations, we require the ability to move excess net capital among these entities. Such allocations are made to facilitate liquidity where needed most, while most efficiently assuring customer and counter-party protection. Of course, these allocations regard excess capital only. Faced with the prospect that such monies, once contributed to a given broker-dealer, would be arrested indefinitely and for at least a year absent Examining Authority approval to withdraw, SIG would become reticent to contribute excess capital, and would become more conservative in making such contributions. This would result in a lessening of broker-dealer liquidity rather than a vigorous promotion of liquidity where needed most.

The Proposed Provision is Ambiguous

Aside from the basic uncertainty of what is meant by "permanent" and "temporary" capital, the proposed rule is materially ambiguous. Paragraph (c)(2)(i)(G) does not say whether a LIFO or FIFO method should be used in assessing whether a capital withdrawal occurred within a year of contribution. With respect to excess net capital, SIG submits that the FIFO method should be used.

The provision is likewise ambiguously silent on whether and how it would apply to the withdrawal of capital as a result of position reductions and/or trading profits. For example, assume a broker-dealer has a $20 million minimum net capital requirement, and has $50 million in net capital because its investor(s) would like to keep at least $30 million in excess net capital. The broker-dealer then loses $20 million, so the investor(s) contributes $30 million, resulting in a net balance of $60 million. The broker-dealer then makes $10 million, resulting in a net balance of $70 million, but the investor(s) may be prohibited from withdrawing the $10 million by proposed paragraph (c)(2)(i)(G). Any such prohibition to the distribution of trading profits goes too far and would result in the aforementioned chilling effect on capital contributions that is contrary to the Commission's goal of promoting broker-dealer liquidity.

Paragraph (c)(2)(i)(G) is also vague on the meaning of an "agreement that provides the investor with the option to withdraw the capital". Read broadly, this requirement entails that any capital contribution that an investor has the option of withdrawing must be carried as a liability regardless of whether it is withdrawn within a year or at any later time. Indeed, such broad reading of this provision is likely in view of the Release's statement in its costs and benefits analysis that "[t]he proposed amendments also would require a broker-dealer to treat as liabilities capital contributions where the investor has the option to withdraw the capital at any time." The provision gives no comfort that a withdrawal option that was conditional and/or periodic would avoid this result. This prospect goes far beyond the paragraph's other requirement to carry as a liability capital contributions intended to be withdrawn within a year unless the withdrawal is approved by an Examining Authority. In fact, it swallows that requirement and renders it moot. The practical effect is the re-casting of genuine capital as debt, in contravention of every known legal and accounting standard, and the singling out of broker-dealers as subject to this self-contradiction.

The paragraph likewise provides that any withdrawal of capital made within one year of its contribution is presumed to be subject to the deduction from net worth. Although the same subparagraph premises this deduction on an intention to withdraw the capital within a year, the paragraph does not provide guidance on whether the presumption is rebuttable in the face of contrary indicia of intent. A non-rebuttable presumption would belie and obviate any interest in actually gleaning such intent.

Circumstances may cause an investor(s) to withdraw capital within a year of contribution even though the contribution was not made with an intent to withdraw it in that time frame. In that event, all prior net capital determinations would have to be re-calculated and may result in an *ex post facto* determination that the broker-dealer was out of capital compliance. This results in an inequitable and deleterious lack of certainty to broker-dealers.

Cost-Benefit Analysis

In its analysis of costs and benefits, the Commission asserted that the capital treatment requirement would impact only a few broker-dealers, including those that provide investors with options to withdraw capital, but provided no basis for this assertion. The Commission estimated that no more than $100 million in capital at broker-dealers is subject to agreements permitting an owner to withdraw capital at any time, but likewise provided no basis for this estimate. We believe that most owners of broker-dealers, including individuals and parent holding companies, have the option of withdrawing capital, and that the $100 million estimate is far below the scale of magnitude this provision will impact.

The benefits cited by the Commission are that the capital treatment proposal would assist investors and regulators "by requiring broker-dealers to provide a more accurate picture of their financial condition." The Commission said this would "permit regulators to react more quickly if a firm experiences financial difficulty," which would benefit broker-dealer customers and counterparties, and accordingly reduce systemic risk in the securities markets.

The Commission does not explain what it means by "a more accurate picture" of a broker-dealer's financial condition and how this would be achieved by turning capital into debt in contravention of GAAP and other legal standards. Nor does the Commission provide any metrics on how regulators could react more quickly if a firm experiences financial difficulty, and on how this would reduce systemic risk in the securities markets. Moreover, as noted above, the Commission makes out no case that the "Drexel Rules" are not adequate and that there is any reason to deviate from the already established "appropriate balance between the need for increased early warning protection and the ability of broker-dealers to allocate their resources efficiently."

Suggested Remedies

The Commission noted that the concern it was seeking to address by its proposed paragraph (c)(2(i)(G) was "that broker-dealers may be receiving capital contributions from individual investors that are subsequently withdrawn after a short period of time (often less than a year)". Its proposed redress of this concern reaches far beyond the individual investor scenario to constrain all capital contributions to broker-dealers. The broader concern seems to be to assure that capital contributions are enduring and not transient shams to appease technical capital requirements. We agree that a broker-dealer's capital should reflect the genuine net worth that a broker-dealer purports to its customers, counter-parties, and regulators.

SIG believes there are alternatives that better balance the Commission's interest in safeguarding broker-dealer capitalization with legitimate investor interests in capital withdrawals. These alternatives are intended to assure the responsible allocation of assets for purposes of excess net capital above minimum net capital requirements.

Our first suggestion is a two-tiered approach, whereby a given percentage of net worth may be withdrawn from excess net capital at the investor's option, but that examining authority approval would be required for any other withdrawals to the extent they are within a year of contribution. This would assure the durability of excess net capital within the broker-dealer while acknowledging that investors retain ownership of their monies.

Another suggestion is the allowance of broker-dealer distributions of capital to investors in the business judgment of the broker-dealer in consideration of selected criteria to assure the viability of the broker-dealer. Such determinations could be documented to facilitate regulator review that the requisite criteria was addressed in the decision-making process. This alternative would obviate pre-determined holding periods.

Still another alternative is the allowance of unfettered withdrawal of excess net capital up to a given amount by a broker-dealer parent company pursuant to an undertaking with the broker-dealer's examining authority that such given amount will not be channeled away from the parent or its subsidiaries except in pre-defined extraordinary circumstances. This would assure that funds would remain available to be flexibly allocated to address the risk needs of the broker-dealer and its affiliates.

Conclusion

SIG opposes the adoption of the proposal to treat capital contributions as liabilities. It contravenes pertinent legal and accounting standards and is unnecessary in view of existing capital withdrawal limitations and notification requirements that "strike an appropriate balance between the need for increased early warning protection and the ability of broker-dealers to allocate their resources efficiently."

If any further limitation on capital withdrawal is adopted beyond the current provisions of the net capital rule, it should be designed to allow for the flexible ability of broker-dealer holding companies to withdraw excess net capital at their option for legitimate business purposes. We have offered several suggestions and are open to like-minded alternatives.

If the instant proposal is adopted in any form, it should be amended to clarify the uncertainties discussed above. Its silence on these points will subvert due process considerations by facilitating more lore than law.

We appreciate the Commission's consideration of our concerns, and remain available to discuss any matter raised in this letter.

Respectfully,

Richard J. McDonald
Chief Regulatory Counsel

cc: Mary L. Schapiro, Chairman, SEC
Luis A. Aguilar, Commissioner, SEC
Kathleen L. Casey, Commissioner, SEC
Troy A. Paredes, Commissioner, SEC
Elisse B. Walter, Commissioner, SEC
James Brigagliano, Co-Acting Director, Division of Trading and Markets, SEC
Daniel M. Gallagher, Co-Acting Director, Division of Trading and Markets, SEC
Michael Macchiaroli, , Associate Director, Division of Trading and Markets, SEC